

WPS-0139

Policy, Planning, and Research

WORKING PAPERS

Development Economics

Office of the Vice President  
Development Economics  
The World Bank  
January 1989  
WPS 139

# A Conceptual Framework for Adjustment Policies

Bela Balassa

The principal objective of stabilization policies under the auspices of the International Monetary Fund is to improve the balance of payments. In turn, increasing the rate of growth of output may be considered the principal objective of adjustment policies under World Bank auspices.

**Policy, Planning, and Research:**

**WORKING PAPERS**

**Development Economics**

The principal objective of stabilization policies under the auspices of the International Monetary Fund is to improve the balance of payments. In turn, increasing the rate of growth of output may be considered the principal objective of adjustment policies under World Bank auspices.

The growth objective may be pursued by improving the efficiency of using existing resources, adding to available resources, and ensuring the efficient use of these additions to resources. In the first case, production incentives need to be reformed; in the second, incentives are provided to savings and investment; in the third, the choice of alternative investments is the relevant consideration. One may, then, classify policy instruments for adjustment into

three categories, according to whether they affect resource allocation, savings and investment, and the choice of investment.

Policy instruments that can be employed to improve the use of existing resources include exchange rate and trade policy as well as government regulations and measures relating to state enterprises. In turn, measures that may be taken to increase savings and investment comprise reforming tax regulations, establishing realistic interest rates, increasing public savings, developing financial intermediation, and providing investment incentives. Finally, measures that affect the allocation of investment among particular uses pertain to private investment, public investment, or to particular sectors.

This paper is a product of the Office of the Vice President, Development Economics. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Norma Campbell, room S9-047, extension 33769.

The PPR Working Paper Series disseminates the findings of work under way in the Bank's Policy, Planning, and Research Complex. An objective of the series is to get these findings out quickly, even if presentations are less than fully polished. The findings, interpretations, and conclusions in these papers do not necessarily represent official policy of the Bank.

# A CONCEPTUAL FRAMEWORK FOR ADJUSTMENT POLICIES

Bela Balassa\*

## TABLE OF CONTENTS

## Page No.

I.	Stabilization Policies vs. Adjustment Policies . . . . .	1
II.	The Conceptual Framework for Stabilization Programs . . . . .	2
III.	Objectives and Instruments of Adjustment Policies . . . . .	5
IV.	Exchange Rate and Trade Policy . . . . .	6
V.	Government Regulations and Public Enterprises . . . . .	14
VI.	Incentives to Savings and Investment . . . . .	18
VII.	Measures Affecting Investment Allocation . . . . .	24
VIII.	Coordination of Adjustment and Stabilization Policies . . . . .	26
IX.	Adjusting with Equity . . . . .	27
X.	Concluding Remarks . . . . .	28

---

\* The author is Professor of Political Economy at the Johns Hopkins University and Consultant to the World Bank. He prepared this paper as a background paper for the Adjustment Lending Policy Paper.

## A CONCEPTUAL FRAMEWORK FOR ADJUSTMENT POLICIES

Bela Balassa

### I. Stabilization Policies vs. Adjustment Policies

One may base the distinction between stabilization policies and adjustment policies on the policy measures applied or, alternatively, on the policy objectives pursued. While classification by policy measures would seem attractive, it encounters practical difficulties. Thus, the exchange rate is an important instrument for stabilization policies as well as for adjustment policies. Also, monetary and fiscal policies, which are central to stabilization, assume importance for adjustment as well.

The principal objective of stabilization policies under the auspices of the International Monetary Fund is taken to be improving the balance of payments; the IMF generally adds lowering inflation rates as another objective. In turn, increasing the rate of growth of output can be considered the principal objective of adjustment policies under World Bank auspices.

The paper will begin by examining the existing conceptual framework for stabilization policies and inquire into the question as to an appropriate framework for adjustment policies. Next, the instruments of adjustment policies will be briefly reviewed, followed by a discussion of the principal types of policies, including policies aimed at improving the use of existing resources, increasing savings and investment, and ensuring an efficient choice of investments. Furthermore, brief consideration will be given to the coordination of stabilization and adjustment policies and to adjustment with equity.

## II. The Conceptual Framework for Stabilization Programs

The conceptual framework for stabilization programs has been described in a recent paper by the IMF Research Department. <sup>1/</sup> It is stated there that remedying balance-of-payments deficits is the principal objective of these programs. It is added that, since "it is generally easier to reduce absorption than to increase production ..., policies affecting absorption are often first put in place when a rapid decline in a current account deficit is mandatory" (p. 6). Such expenditure-reducing policies are considered in the model described in the paper.

The paper notes that "at the core of every Fund-related program is a basic financial programming framework (p. 13)," reflecting the monetary approach to the balance of payments. In this framework, "the change in net foreign assets will be positive (the balance of payments will be in surplus) to the extent that the change in the money stock exceeds the change in domestic credit" (Ibid). For a given money stock, then, domestic credit restraint will bring about an improvement in the balance of payments.

Domestic credit restraint may involve the private and the public sector. Now, "a ceiling on the expansion of domestic credit to the public sector [is] derived in conjunction with the overall expansion of credit consistent with a balance of payments target and the targeted flow of credit to the private sector. Coupled with a limitation on external borrowing to the public sector, this [yields] an effective limit on the size of the fiscal deficit" (pp. 24-25).

---

<sup>1/</sup> "Theoretical Aspects of the Design of Fund-supported Adjustment Programs," Occasional Paper 55, Washington, D.C., International Monetary Fund, 1987, p. 6.

Thus, the financial programming framework starts out with a balance of payments target and proceeds to consider, first, monetary and, subsequently, fiscal variables as policy instruments in the pursuit of this target. Monetary and fiscal policies, then, represent the principal instruments used in stabilization programs.

In another paper, written for the World Bank by economists who were previously, and are now again, employees of the IMF, the financial programming framework is extended to include also reducing domestic inflation as a target.<sup>1/</sup> This involves adding the exchange rate as a policy instrument. In turn, real output, exports, capital flows, and the international price of imports are exogenous variables (the first three exogenous variables are introduced in the previous model as well).

Both variants of the financial programming framework are limited to issues of stabilization. In the paper cited earlier, it is claimed however that "the promotion of sustained growth has always been a major concern of the Fund" (p. 27) and that growth aspects have received increased attention in recent years. It is added that "there is therefore increasing relevance to extending the basic financial programming model to incorporate the economic variables and relationships that are crucial for meeting growth objectives. To do so, however, is a formidable task, and studies aimed at doing so have only begun to suggest ways in which the financial programming framework can be extended" (Ibid).

---

<sup>1/</sup> Mohsin S. Khan, Peter Montiel, and Nadeem U. Haque, "Adjustment with Growth: Relating the Analytical Approaches of the World Bank and the IMF." Development Policy Issues Series Discussion Papers No. VPERS8, Washington, D.C. World Bank, 1986.

Such an attempt has been made in the Khan, Montiel, Haque paper cited above in attempting to combine the Fund and the Bank approaches. The paper has a fatal defect, however, of identifying the Bank approach with a two-gap model, in which exports are exogenous and the incremental capital-output ratio, the import propensity, and the savings rate are given ex ante (Section IV). While this greatly eases the task of combining the two models, it takes relationships as given that are to change under adjustment programs.

Thus, adjustment programs generally aim at increasing exports. They also aim at raising efficiency levels, involving reductions in the incremental capital-output ratio, include measures affecting imports, and aim at increasing savings rates. The proposed model, however, fails to consider the effects of adjustment policies on these variables.

Could one, then, model adjustment policies? Simple models could be derived without much difficulty, taking economic growth as the ultimate target, introducing exports, imports, savings, and investment as intermediate targets, and utilizing a number of policy instruments, such as the exchange rate, the interest rate, export incentives, import protection, and pricing policies. To make the model realistic, however, would require making it very complicated. At the same time, our knowledge of the factors affecting the efficiency of resource use is woefully inadequate, although this plays an important role in adjustment programs. Also, we know little of factors affecting savings and investment.

This being the case, a more "literary" approach is suggested. This would involve adopting an overall framework for adjustment policies. Such a framework would include the policies that can be used to pursue the stated objective.

### III. Objectives and Instruments of Adjustment Policies <sup>1/</sup>

As noted above, the primary objective of adjustment policies is increasing the rate of economic growth. This objective may be pursued by improving the efficiency of using existing resources, adding to available resources, and ensuring the efficient use of these additions to resources. In the first case, production incentives need to be reformed; in the second, incentives need to be provided to savings and investment; in the third, the choice of alternative investments is the relevant consideration.

One may, then, classify policy instruments for adjustment into three groups, according to whether they affect resource allocation, savings and investment, and the choice of investments. At the same time, it should be recognized that these instruments are interdependent and will generally interact in the pursuit of particular goals.

For example, the choice of the exchange rate will affect not only the allocation of existing resources but also the availability of additional resources through its impact on capital flight. Furthermore, while interest rate policy may aim at increasing savings, high (low) interest rates will disfavor (favor) capital-intensive activities. Finally, sectoral policies, which aim at promoting investment in particular activities, have a bearing on the allocation of existing resources as well.

While recognizing these interactions, the following discussion of the three groups of policy instruments will give emphasis to their primary

---

<sup>1/</sup> The following discussion draws on Bela Balassa, "Structural Adjustment Policies in Developing Countries," World Development, January 1982 and "Structural Adjustment Policies: Conceptual Issues," October 1987.



effects. Following a brief statement on these policy instruments, they will be considered individually.

Policy measures that can be employed to improve the use of existing resources will be considered in two parts: exchange rate and trade policy and government regulations and state enterprises. Under the first heading, a review of the exchange rate-import protection-export subsidy nexus will be followed by a discussion of the need to grant export subsidies, reduce and equalize import protection, and maintain realistic exchange rates. Under the second heading, the need to decontrol prices and eliminate subsidies will be considered, with further attention given to the desirability of deregulation and privatization.

A variety of measures may be taken to increase savings and investment in developing countries. The discussion will focus on reforming tax regulations, establishing realistic interest rates, increasing public savings, developing financial intermediation, and providing investment incentives.

There are further measures that affect the allocation of investment among alternative uses. They may pertain to private investment, public investment, or to particular sectors.

#### IV. Exchange Rate and Trade Policy

The exchange rate-import protection-export subsidy nexus is of primary importance as far as production incentives are concerned. These measures are interdependent in their effects on productive activities, and they can be used in alternative ways to influence the allocation of economic resources. For example, imposing import tariffs of 20 percent and granting a 20 percent export subsidy across-the-board would have the same impact on productive activities as a 20 percent devaluation.

Conceptually, then, a devaluation is equivalent to a combination of import tariffs and export subsidies. There are differences, however, in the international acceptability of these measures. Also, countries may have taken a commitment to forego the use of a particular measure.

A country may generally vary its exchange rate at will. Also, developing countries can vary their measures of protection unless binding them under GATT rules. In turn, foreign nations may apply retaliatory measures in response to export subsidies that are deemed to injure their domestic industries.

But, countries may forego variations in exchange rates by de jure and de facto joining a currency area. The example par excellence is participation in the franc area that involves maintaining the exchange rate fixed vis-à-vis the French franc. And, there are several countries in Central America and elsewhere, which have in practice tied their exchange rates to the U.S. dollar.

Apart from the case when the exchange rate is fixed, a devaluation (or, alternatively, its equivalent, an import tariff export subsidy scheme) may be utilized to remedy a balance of payments deficit in a developing country where optimal policies have been applied. But, in developing countries in general, there is excessive import protection of manufacturing activities, with a consequent bias against manufactured and primary exports and against primary activities in general. It would be desirable, then, to reduce this bias so as to improve the efficiency of resource allocation.

Using tariff reductions for this purpose would, however, bring a further deterioration in the balance of payments, unless accompanied by a devaluation of the exchange rate. If an across-the-board tariff reduction is

accompanied by a devaluation of a commensurate magnitude, import prices would remain unchanged while export prices would rise at the same rate as the devaluation, thereby reducing the bias against exports.

The described procedure is equivalent to providing an implicit export subsidy. The same result may be achieved by granting an explicit export subsidy at identical rates. The conceptual equivalence of a partially compensated devaluation and an across-the-board export subsidy may be illustrated by an example.

Assume that initially the exchange rate is 100 pesos to the dollar, all imports are subject to a tariff of 50 percent, and export subsidies are not provided. Under the first alternative, reducing tariffs by one-half, accompanied by a 20 percent devaluation, would leave the domestic prices of imports unchanged while raising export prices by 20 percent. Under the second alternative, the 20 percent increase in the prices of exports would be attained by granting a 20 percent export subsidy across-the-board.

In affecting the prices of imports and exports in the same way, the described alternatives would have identical effects on the balance of payments, domestic inflation, and the government budget. The balance of payments would improve as exports rise in response to increased incentives. Also, the inflationary effects of the devaluation on imports would be offset by commensurate reductions in tariffs, so that these effects would be limited to increases in export prices, just as in the case of (explicit) export subsidies. And, under both alternatives, there would be a cost to the government budget: the loss of tariff proceeds in the first case and the budgetary cost of export subsidies in the second. However, this budgetary

cost would be recouped in part through tax receipts on higher incomes and consumption following the expansion of exports.

Complications are introduced if exports use imported inputs. In the case when imported inputs utilized directly and indirectly in export production enter duty free, a devaluation will raise export prices as well as the prices of imported inputs. To obtain equivalent results, export subsidies would need to be set on value added in exports -- the difference between the fob export value and the cif value of imported inputs used directly and indirectly in export production -- rather than on export value.

Deducting the cif value of direct and indirect imported inputs from export value may involve administrative problems. The same comment applies to granting export subsidies to a large number of peasant proprietors. Extending export subsidies to earnings from service items, among which tourism is of considerable importance for many developing countries, may also encounter administrative difficulties.

These considerations, then, favor a devaluation cum tariff reduction over an export subsidy. A further advantage of the former alternative is that it would reduce discrimination against products that are subject to duties at rates lower than the devaluation or enter duty free. This is because such products will enjoy the partial or the full benefit of a devaluation through increases in their domestic prices.

In developing countries, agricultural products, some intermediate goods, energy products, and capital goods are often subject to low or nil duties, thereby suffering discrimination vis-à-vis products with higher tariffs. A devaluation, partially compensated by tariff reductions, then, would encourage efficient import substitution in these products.

The preceding considerations point to the advantages of a partially compensated devaluation over an export subsidy. These conclusions are further strengthened if account is taken of the danger of retaliation by importing countries against an export subsidy.

Export subsidies would have to be utilized, however, if fixed exchange rates are maintained as in the franc area. Also, in the presence of continued import protection, export subsidies would improve the efficiency of resource allocation by reducing the bias of the system of incentives against exports.

In the event that export subsidies are to be employed, developing countries will wish to minimize the chances of retaliation on the part of developed countries. This objective may be served by applying measures that are accepted or countenanced by GATT.

Exempting exports and their direct and indirect inputs from indirect taxes and rebating duties on imported inputs are accepted by GATT. In fact, exemptions from indirect taxes do not represent an export subsidy; rather, they are necessary to ensure tax neutrality on domestic and foreign sales, thereby avoiding taxing exports. At the same time, shifting from income taxes to indirect taxes can be used to increase incentives to exports.

Note further that rebating duties on imported inputs used in export production will reduce but not eliminate the bias against exports. Thus, a 20 percent tariff on the product and its imported inputs will still provide a 20 percent protection on value added in import substitution as against zero protection on value added in exports that obtain their imported inputs duty free.

There are some further measures benefiting exports, which are not usually met with retaliation. They include preferential export credits that reduce the disadvantages of developing country exporters, which are due to the undeveloped state of credit facilities and the riskiness of entering export markets. Also, the government may share the cost of entering new markets through tax concessions on marketing expenditures as well as through the collection of information, market research, and trade fairs organized or partly financed by quasi-governmental bodies. Finally, the government may finance improvements in infrastructure that benefit export activities.

Going beyond these measures and granting explicit subsidies to exports will invoke retaliation if they cause injury to the domestic industries of foreign countries. However, small developing country exporters have little to fear from retaliation because they are not likely to cause injury abroad. Thus, the application of export subsidies by the franc area countries, which cannot devalue their currencies, is unlikely to trigger countervailing measures.

In view of the limitations imposed on export subsidies by developing countries in general, there is need to reduce and to rationalize import protection. In order to minimize dislocation, the reform of the system of protection should be carried out over a period of, say, 4 to 5 years. At the same time, the measures to be applied should be made public in advance so as to prepare firms for the necessary adjustment.

In reforming the system of protection, priority should be given to eliminating quantitative import restrictions that have a variety of disadvantages compared to tariffs. While the extent of tariff protection can be easily ascertained, gauging the protective effect of quantitative import

restrictions, and their cost to the national economy, would necessitate comparisons of domestic and foreign prices. Price comparisons, however, encounter practical difficulties on all but standardized products, because of differences in quality, specifications, and other product characteristics. Decision making in the granting of import licenses thus involves considerable arbitrariness and increases uncertainty to the users of imported inputs.

Also, tariffs add to government revenue while the difference between the domestic and the import price accrues to the importer under licensing. Such quota profits, reflecting the scarcity of imports, may lead to overcrowding in individual industries through the establishment of firms for the purpose of sharing these profits and provide inducement for bribery.

It has been suggested that tariffs be raised in order to offset the loss of protection to domestic producers, owing to the elimination of quantitative import restrictions. But, unless provisions are made for the elimination of additional tariff protection over time, there is the danger that the higher tariffs will become imbedded in the system of import protection. Furthermore, producers will clamor for tariffs in excess of the extent of protection provided by the quantitative restrictions, and their claims will be difficult to evaluate, given the uncertainties involved in measuring the tariff equivalent of quantitative import restrictions.

In fact, it would be desirable to undertake tariff reforms parallel with the elimination of quantitative import restrictions. This would permit the application of a coordinated approach and allow for adjustment in protected industries. An appropriate procedure is to make changes in steps within an announced timetable as suggested above.

In regard to quantitative import restrictions, one may begin by liberalizing the importation of material inputs and machinery used in export production, with the freeing of such inputs utilized in domestic production undertaken at the second stage. Next, consumer goods for general use may be liberalized, with luxury products left to the last stage.

Reforming tariffs should aim at equalizing effective rates of protection on value added across the board. This can be accomplished by setting equal tariffs at each stage of the production process. Such a goal may be approached through several steps.

First of all, there would be need to set a tariff ceiling and reduce the ceiling over time. This should also involve transforming tariffs on luxury goods into excise taxes that would apply to imported and to domestic products as well.

Also, high tariffs should be reduced more than low tariffs. This squeezing of the tariff structure would have more than proportionate effects on effective rates of protection (the rate of protection on value added in the production process), which magnify differences in (nominal) tariff rates at different stages of fabrication.

A more controversial proposal involves imposing tariffs on duty free items. This would, on the one hand, reduce discrimination against the products in question and, on the other hand, lower effective protection on the products that use them as inputs. At the same time, these tariffs should not be higher than the long term tariff target, say 10-12 percent, lest temporary incentives are provided to the industries in question while discriminating against exports.



Additional measures may be granted to the benefit of infant industries on a temporary basis and on a degressive scale. But these measures should also promote exports. This may be accomplished by providing investment incentives that will be discussed below.

Reducing import protection over time may necessitate changes in exchange rates so as to safeguard the balance of payments. But this is far from certain since export incentives, as well as reductions in the bias against exports associated with import liberalization, would contribute to export expansion.

Assuming that changes in protection do not require changes in exchange rates beyond the initial compensated devaluation, there is need to avoid variations in real exchange rates unless external or internal shocks alter the equilibrium exchange rate. Particular importance attaches to the fact that an appreciation of the exchange rate would discriminate against exports and engender capital flight.

Capital flight, through the underinvoicing of exports and the overinvoicing of imports, is also an important drawback of dual exchange rates. At the same time, dual exchange rates subsidize imports and the sale of foreign financial assets while taxing exports and the purchase of foreign financial assets. The improved allocation of existing resources calls for eliminating such taxes and subsidies by adopting a single exchange rate.

#### V. Government Regulations and Public Enterprises

Price control is often used in conjunction with import protection, in order to limit profits to producers in monopoly situations or if collusive oligopolists dominate the protected market. Conversely, liberalizing trade will permit eliminating price control.

Price control may also aim at avoiding increases in the prices of particular inputs and of consumer goods. But, as production is discouraged and consumption encouraged as a result, exports will decline or imports rise, leading to the deterioration of the balance of payments and to inefficient resource use.

In the case of inputs, distortions in relative prices further reduce the efficiency of resource allocation. Also, price controls on inputs, such as electricity, fuel oil, and gasoline, encourage their wasteful use. To the extent that these products and services are produced by public enterprises, price control further contributes to the public sector deficit, thereby increasing inflationary pressures.

Price control on consumer goods is often used to avoid increases in the prices of necessities, supposedly to the benefit of the poor. But it may eventually have the opposite effect by limiting supply in discouraging production. Also, price control benefits all users, irrespective of their income position. And, the benefits are mitigated by shortages, necessitating formal or informal rationing, if sufficient supplies are not available at the controlled price. Last but not least, in most developing countries, the poor strata of the population importantly include agricultural producers who are adversely affected by price control.

It has been suggested that income distributional objectives be served by using consumption subsidies instead of price control. But, these subsidies have a budgetary cost; they increase demand for the product in question; and, being untargeted, they are an inefficient way of pursuing income distributional objectives. A superior alternative is to use targeted subsidies to benefit the poor.

These considerations indicate the need to eliminate price control and to pursue income distributional objectives through targeted subsidies rather than by subsidizing consumption. It would further be desirable to liberalize government regulations that circumscribe the activities of private business in many developing countries. The regulations may have been established by legislation and government decrees, but their implementation generally involves case-by-case decision-making on the part of government administration. In practice, this may lead to endless trámites (bureaucratic red tape), to use a Latin American expression, and may engender bribery.

Government regulations may extend to the establishment of the firm as well as to its operations. In so doing, they may compromise the success of trade liberalization that requires freedom in setting up new enterprises and in firm operations in order to respond to the needs of foreign markets.

In view of the cost of complying with extensive regulations, the regulations discriminate against small- and medium-size firms that cannot afford the cost and the time involved. Also, inducement is provided to the informal sector, which avoids the cost of regulations but does not enjoy the protection of the law, so that its further development is thwarted.

Deregulation would improve the use of resources. This would occur by reducing the need for a large government apparatus, lowering the cost of complying with the regulations for the firm, and avoiding discrimination against small- and medium-size firms. At the same time, opportunities would be provided for the integration of the informal sector in the national economy.

Establishing a modern legal framework to safeguard property and contractual rights would further contribute to the better use of existing

resources. This objective would also be served by setting up a modern bankruptcy system that facilitates the transfer of assets of loss-making enterprises to more efficient users.

Moreover, labor regulations would need to be modified. In developing countries, labor costs are often raised by high redundancy payments or by outright prohibition of discharging workers. At the same time, these regulations have been shown to have the opposite of the desired effect by discouraging hiring.

High social charges also have adverse effects on employment by increasing the cost of labor. The same conclusion holds for excessively high statutory minimum wages that further create distortions between the formal sector and the informal sector, where such regulations do not apply.

Deregulation would permit firms to better respond to market signals and thus make trade policy reform more effective. Public enterprises, however, tend to respond to bureaucratic imperatives rather than to market signals. The improved use of existing resources would then require that public enterprises conform to the rules to which private enterprises are subject.

To accomplish this objective, public enterprises in the competitive sector should be given freedom of decision making, with profit maximization as the overriding objective. Also, they should be put on the same footing as private enterprises in terms of credits, taxation, and government regulations. Public utilities, too, should be managed on the basis of economic principles.

Most public utilities are natural monopolies, hence there is a rationale for public ownership. Noneconomic considerations also often call

for the public ownership of natural resource industries. But, downstream activities and other industries and services can best be left to private enterprise.

It follows that privatization can lead to improvements in concentrating the government's activities in areas, such as the provision of social services, where it has a comparative advantage. Privatization should be defined as the transfer of control. The sale of minority participation in public enterprises does not qualify as privatization; in fact, it represents the increased use of private funds in the public sector.

At the same time, one would have to create the appropriate conditions for privatization. This would necessitate, first of all, establishing clear and unambiguous procedural rules and applying these rules in practice. The rules should provide for the valuation of the enterprises to be privatized by an independent board, which may use auctioning or other methods appropriate for the conditions of the country concerned. This is to avoid both underpricing and putting an excessively high value on assets of doubtful productivity.

It would also be desirable for the state to undertake the rationalization of the enterprise prior to privatization, so as to eliminate excessive debt and reduce overmanning. In some cases, parts of the enterprise may be rehabilitated while others would have to be closed down. And, there will be public enterprises beyond rescue that will have to be closed down altogether.

#### VI. Incentives to Savings and Investment

A variety of measures may be used to encourage domestic savings in developing countries. Some of these measures also discourage capital flight,

thereby increasing the availability of savings for domestic investment. This result may also be obtained through increased foreign investment.

Improvements in the tax system would encourage private savings, discourage capital flight, and encourage foreign direct investment in developing countries. The improvements may extend to corporate and personal income taxes as well as to indirect taxes.

High and progressive corporate income tax rates reduce business savings and discourage foreign direct investment. The situation is aggravated by the lack of inflation accounting in many developing countries that leads to the taxation of "phantom" profits, by failing to provide full adjustment for the depreciation of machinery and equipment.

In many developing countries, the double taxation of dividends reduces the amounts available for private savings. Personal savings are also adversely affected by highly progressive income taxes. Such taxes further discourage foreign direct investment, by necessitating higher pre-tax salaries for leading employees, and encourage emigration.

Personal savings are discouraged and capital flight encouraged by the taxation of nominal interest income, which does not allow for the fact that the principal loses value through inflation. Also, personal savings are discouraged by the taxation of savings under income taxes, which favors present over future consumption that is the result of today's savings.

The availability of savings for domestic investment could be increased by lowering corporate income tax rates, introducing inflation accounting in corporate and personal income taxes, eliminating the double taxation of dividends, and reducing the progressivity of personal income taxes. Ideally, income taxes should be replaced by a tax on consumption, when

income distributional objectives can be pursued by taxing luxury consumption and providing exemptions for basic necessities.

There is evidence that savings are discouraged by negative real interest rates. For one thing, the holding of financial assets with negative rates of return is discouraged. For another thing, incentives are provided to accumulate consumer durables as an inflation hedge. At the same time, there are inducements for capital flight in search of higher returns abroad.

Negative real interest rates also create an excess demand for funds, thereby leading to credit rationing and inefficient credit allocation. Available credits are often allocated to state enterprises and large firms, thereby limiting the availability of credit to medium-size and small enterprises. Also, import-substitution activities are generally favored, irrespective of whether credit allocation is done by the banks or by governments. Banks favor these activities because they involve lower risks than exports while governments favor them as part of a strategy of import protection.

Negative real interest rates further provide inducement for investment in capital-intensive activities and for the use of capital-intensive production methods. At the same time, firms may borrow at negative real interest rates as an inflation hedge and accumulate inventories rather than undertaking new investments. Also, self-investment at low, and even negative, rates of return is favored over lending at negative real interest rates and, more generally, the development of financial intermediation is discouraged.

These considerations indicate the need for positive real interest rates that equate the demand for, and the supply of, credit. However,

excessively high real interest rates have adverse effects of their own, by discouraging investment and leading to the bankruptcy of firms whose continued operation is socially desirable.

Excessively high interest rates can be avoided if the deficit of the public sector is reduced. In fact, lowering the deficit creates a "virtuous circle," inasmuch as the resulting decline in interest rates further lowers the deficit by reducing the cost of servicing the domestic debt, generating an additional decline in interest rates and so on.

Thus, reducing public sector deficits is an important part of interest rate policy and, more generally, adjustment policies. One can in this way avoid excessively high interest rates and the crowding out of private investment that has occurred in recent years in a number of developing countries with high public sector deficits.

Apart from cutting excessive public investment, to be discussed further below, lowering the public sector deficit requires reducing the size of the government apparatus and limiting subsidies. The former can be accomplished in conjunction with deregulation while the latter can be accompanied by targeted measures to help the poor.

It has been suggested that taxes be increased in order to raise public savings. In view of the high taxation of economic activities in most developing countries, however, higher taxes will have adverse effects on work and risk-taking. Rather, the emphasis should be put on generating public savings through reductions in government expenditures that would also increase the availability of financial resources to the private sector.

Public savings could further be increased through privatization, the closing down of hopelessly inefficient public enterprises, and the



rationalization of those remaining. In this way, savings in the public enterprise sector would add to savings in the government budget.

Market-clearing interest rates at realistic levels would contribute to the development of financial intermediation by providing inducement for financial savings and furthering their efficient allocation. Pursuing this objective would also necessitate avoiding the use of preferential credit schemes and of directed credit in particular sectors.

At the same time, improvements in the system of financial intermediation are necessary in order to capture the full benefits of interest rate reform. Reforms of the financial system should serve the twin objectives of ensuring that investors face identical credit conditions and that there is competition among banks and other financial intermediaries. Legalizing curb markets, easing the conditions of entry into commercial banking, and encouraging the establishment of other financial intermediaries will promote these objectives.

In a number of developing countries, it would further be necessary to rehabilitate viable banks and other financial institutions that are in difficulties and closing down those that are not viable. This is a particular problem in highly indebted countries where foreign debts burden the banks or their major borrowers.

At the same time, strict rules would need to be established on banking operations, including the preparation of financial statements, the classification of loans, the establishment of loan reserves, and write-offs for non-performing loans. Financial statements should convey adequate information on the quality of bank assets and should be regularly audited, with rigorous banking supervision under the aegis of the central bank.

Governments should further avoid excessively high reserve requirements and taxes on financial transactions, which create a wedge between interest rates paid by borrowers and received by lenders. This again tends to discourage savings and encourage self-investment to the detriment of investments that are socially desirable.

Finally, financial intermediation in long-term obligations should be developed, both to respond to demand for such obligations on the part of savers and to provide financing for long-term investments. Apart from the transformation of the banking system, possibly involving the extension of the activities of commercial banks to long term finance and the establishment of investment banks, the development of capital markets would serve these objectives. Countries which possess the necessary degree of financial sophistication are well-advised to create the conditions for the establishment and, if they exist, the further development of stock and bond markets.

While positive real interest rates will increase the amount of savings available for investment and improve the allocation of these savings, investment incentives will induce firms to increase the share of retained earnings available for investment. Investment incentives have a role to play as adjustment policies aim at the acceleration of economic growth.

The incentives should be granted in a form that does not create a bias in favor of capital-intensive activities. Accelerated depreciation provisions, low or nil tariffs on imported machinery and equipment, and the imposition of minimum investment requirements as a condition for obtaining investment incentives give rise to such a bias. Tax holidays will be a more appropriate measure as they are neutral in their effects on factor use.

## VII. Measures Affecting Investment Allocation

Investment incentives should be provided across the board, with higher incentives to export activities that suffer discrimination under import protection. Investment promotion is not warranted, however, in the event of foreign market limitations in the form of export quotas. Examples are coffee exports under the International Coffee Agreement and petroleum exports under OPEC. The exports of textiles and clothing do not come into this category, however, because of the possibilities for product upgrading under the Multifiber Arrangement and for sales outside the MFA.

Also, investment incentives are eminently suitable for promoting infant industries as they do not discriminate in favor of import substitution and against export activities. This is the case, in particular, in industries producing durable producer and consumer goods, where economies of scale and cost reductions through specialization in the production of parts, components, and accessories would be foregone and possibilities for subsequent exports reduced, if excessive reliance was based on the protection of infant industries.

These considerations apply to private enterprises as well as to firms producing traded goods under competition in the public sector. Other public sector investments pertain to public utilities, social and physical infrastructure, as well as to natural resource industries. Also, in developing countries where the private sector does not have sufficient financing, the government may play a role in promoting large investments in basic industries.

Public investments should be subject to economic project evaluation. This may be done by a separate entity established for this

purpose, so as to ensure uniformity in the methods and criteria applied in project evaluation and to provide for a review of proposals prepared under the aegis of governmental agencies that will eventually implement the project. Following a review of possible alternatives, final decision on public investment could then be made by an interministerial committee.

In the case of large projects, it is desirable to make public the results of project evaluation prior to taking decisions and to invite debate on the desirability of the projects in question. Information should also be made available on direct and indirect subsidies, which may be granted to the project in the form of tariff protection, project-specific infrastructure, and the provision of inputs below world market prices.

Project evaluation assumes particular importance by reason of the need to rationalize the public investment program in the framework of structural investment policies. In fact, the adoption of adjustment policies provides an opportunity for a review of public investment extending beyond the evaluation of new investments, so as to consider the possibility of stopping or discontinuing ongoing investments if they do not hold sufficient promise.

The adoption of adjustment policies also provides an opportunity for the formulation of sectoral policies. In this connection, distinction may be made between sectors where the state has a major responsibility, such as public utilities and education, and sectors where the government may support the operation of market processes.

In the case of sectors where the government has a major responsibility, there is need to specify medium-term objectives that may be pursued in the framework of a co-ordinated program. Further importance

attaches to fitting individual projects in the program and undertaking the evaluation of these projects as noted above.

Government support of the operation of market processes is called upon to different degrees in sectors producing traded goods under competition. They are related to market failures, where markets cannot ensure the efficient utilization of resources and the long-term development of a particular sector.

A case in point is agriculture, where sectoral policies may involve undertaking government-sponsored research, establishing extension services, providing high-quality seeds, and improving transportation facilities. However, public agencies assuming the tasks traditionally performed by private interests, such as the processing and marketing of agricultural produce and the purchase of inputs for agriculture, has generally involved inefficiencies and high costs.

More generally, sectoral policies should not be used to distort resource allocation through government intervention in market processes. Rather, the objective should be to support the operation of market processes that permit accelerating economic growth.

#### VIII. Coordination of Adjustment and Stabilization Policies

While adjustment policies aim at accelerating economic growth, most developing countries -- in particular, highly-indebted countries -- also need to reduce their balance of payments deficits. In this connection, distinction may be made among countries on the basis of whether they have or do not have IMF programs.

In the case of countries with IMF programs, there is need to ensure that Bank and IMF programs are mutually supportive. This may be accomplished

through coordination by the staff of the two institutions.

In countries without an IMF program, the Bank is called upon also to deal with monetary and fiscal policies. At the same time, as a general guideline, the policies applied to improve the balance of payments should aim at doing so by output-increasing rather than expenditure-reducing measures.

The (partially) compensated devaluation, discussed earlier, is a par excellence output-increasing policy. This is because it promotes exports and the production of import substitutes that were subject to low or nil protection while keeping the prices of other import substitutes unchanged.

But, expenditure-reducing policies could not be foregone. In the absence of such policies, there is the danger that inflation accelerates. Also, as noted above, reductions in government expenditures permit increasing the availability of funds to the private sector, thus exploiting its growth potential.

#### IX. Adjusting with Equity

A judicious choice of policies can ensure that improvements in the balance of payments are not made at the expense of economic growth. Nevertheless, the process of adjustment may involve costs to the poor. Such costs may be the result of shifts in resources or the phasing out of price control and consumer subsidies.

To the extent that adjustment involves unemployment in particular sectors, attention would need to be given to retraining, so as to transform existing skills in a way that they become marketable. Retraining may be complemented by the creation of opportunities for productive employment in areas such as road maintenance and small-scale irrigation.

In replacement of price control and consumer subsidies, well-targeted programs benefiting the poor should be relied upon. Such programs may focus on food distribution, targeting in particular pregnant women and school children in poor areas; on primary health care, emphasizing prevention; and on education, concentrating on primary schooling.

Some of these programs may be financed through the elimination of price control on goods and services produced by public enterprises and the abolition of subsidies. Others may involve the imposition of user charges; e.g. by having the well-to-do finance the education of their children.

#### X. Concluding Remarks

This paper has defined adjustment policies in terms of the objective of accelerating economic growth. This objective may be pursued by various policies aimed at improving the use of existing resources, adding to these resources, and ensuring the efficient allocation of resource increments.

The described policies range over a wide spectrum, encompassing macro as well as micro policies. There is also a mixture of changes in relative prices and institutional reform. As to the former, reducing the bias of the incentive system against exports would need to be accompanied by changes in factor prices as existing measures tend to burden labor and favor capital in most developing countries. As to the latter, changes in the status and operation of public enterprises and the introduction of economic project evaluation in public investments are of particular importance.

The various elements of adjustment policies need to be coordinated in order to ensure their maximum effectiveness. But, different policies may receive emphasis in different countries and at different times, depending on the existing conditions.

In this connection, a distinction may be made between structural adjustment policies and sectoral policies. Structural adjustment policies concern the entire economy and will cover most, although not necessarily all, of the areas discussed in this paper. In turn, as the name indicates, sectoral adjustment policies concentrate on a particular sector, with supporting policies in other areas.

In this connection, questions may be raised about the sequencing of structural adjustment and sectoral policies. As a general rule, it is appropriate to start with structural adjustment policies that will provide a framework in which sectoral adjustment policies can operate.

Note should further be taken of the time element involved. There are time lags in the working of adjustment policies, so that the time horizon of adjustment programs should not be too short. Nor should these programs extend over an excessively long period that would increase expectations about policy reversals.

The last point leads to the important issue of ensuring that structural adjustment programs are credible. This means that decisions need to be reached in advance, with a timetable provided for their implementation. At the same time, the measures to be taken should be well publicized, so as to prepare the affected industries for the prospective changes.

In practice, ideal policies cannot be established by one fell swoop. Thus, one needs to envisage a sequence of adjustment programs. At the same time, it is important to understand the overall objectives at the outset, so as not to lose sight of the "big picture" in reforming policies.



The paper further noted the need for the coordination of adjustment and stabilization policies. Also, consideration needs to be given to the political constraints and to the income distributional effects of the policies applied. The paper described possible measures that may be taken to ease any adverse consequences the policies applied may have on the poor.

PPR Working Paper Series

	<u>Title</u>	<u>Author</u>	<u>Date</u>	<u>Contact</u>
WPS118	Contract-Plans and Public Enterprise Performance	John Nellis	October 1988	R. Malcolm 61707
WPS119	Recent Developments in Commodity Modeling: A World Bank Focus	Walter C. Labys	October 1988	A. Daruwala 33716
WPS120	Public Policy and Private Investment in Turkey	Ajay Chhibber Sweder van Wijnbergen	October 1988	A. Bhalla 60359
WPS121	Commercial Bank Provisioning Against Claims on Developing Countries	Graham Bird	October 1988	I. Holloman-Williams 33729
WPS122	Import Demand in Developing Countries	Riccardo Faini Lant Pritchett Fernando Clavijo	November 1988	K. Cabana 61539
WPS123	Export Supply, Capacity and Relative Prices	Riccardo Faini	November 1988	K. Cabana 61539
WPS124	International Macroeconomic Adjustment, 1987-1992: A World Model Approach	Robert E. King Helena Tang	November 1988	K. Adams 33738
WPS125	The Effects of Financial Liberalization on Thailand, Indonesia and the Philippines	Christophe Chamley Qaizar Hussain	October 1988	A. Bhalla 60359
WPS126	Educating Managers for Business and Government: A Review of International Experience	Samuel Paul John C. Ickis Jacob Levitsky	November 1988	E. Madrona 61711
WPS127	Linking Development, Trade, and Debt Strategies in Highly Indebted Countries	Ishac Diwan	November 1988	I. Diwan 33910
WPS128	Public Finances in Adjustment Programs	Ajay Chhibber J. Khalilzadeh-Shirazi	December 1988	A. Bhalla 60359

PPR Working Paper Series

	<u>Title</u>	<u>Author</u>	<u>Date</u>	<u>Contact</u>
WPS129	Women in Development: Defining the Issues	Paul Collier	December 1988	J. Klous 33745
WPS130	Maternal Education and the Vicious Circle of High Fertility and Malnutrition: An Analytic Survey	Matthew Lockwood Paul Collier	December 1988	J. Klous 33745
WPS131	Implementing Direct Consumption Taxes in Developing Countries	George R. Zodrow Charles E. McLure, Jr.	December 1988	A. Bhalla 60359
WPS132	Is the Discount on the Secondary Market A Case for LDC Debt Relief?	Daniel Cohen	November 1988	M. Luna 33729
WPS133	Lewis Through a Looking Glass: Public Sector Employment, Rent-Seeking and Economic Growth	Alan Gelb J.B. Knight R.H. Sabot	November 1988	A. Hodges 61268
WPS134	International Trade in Financial Services	Silvia B. Sagari		
WPS135	PPR Working Papers Catalog of Numbers 1 to 105	PPR Dissem. Center	November 1988	Ann Van Aken 31022
WPS136	Pricing Commodity Bonds Using Binomial Option Pricing	Raghuram Rajan	December 1988	J. Raulin 33715
WPS137	Trends in Nontariff Barriers of Developed Countries: 1966 to 1986	Sam Laird Alexander Yeats	December 1988	J. Epps 33710
WPS138	Fiscal Adjustment and Deficit Financing During the Debt Crisis	William R. Easterly		
WPS139	A Conceptual Framework for Adjustment Policies	Bela Balassa	January 1989	N. Campbell 33769